

Directors' Rewards: A Compliance-Focused Reappraisal

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I. Introduction

The conventional normative principle for the public corporation is that managers should run the firm so as to maximize shareholder value within the constraints otherwise imposed by law and that in so doing, managers will both serve the interests of shareholders and society. The board, staffed by independent directors, is charged with monitoring management in connection with its performance on this criterion.

In light of shareholders' attenuated control rights, a centerpiece of corporate governance for the last two decades has been to reward managers, through stock-based compensation, for delivering value to shareholders. As is well-known, this gives managers 'high-powered' incentives to seek shareholder returns. A downside of high-powered managerial incentives, however, is their tendency to crowd out other considerations. Managers can be tempted to put the delivery of short-term stock price gains, triggering compensation payouts, ahead of longer-term considerations including the firm's compliance with the constraints imposed by law. And, as shown most vividly by the financial crisis, single-minded pursuit of own-firm shareholder value can lead firms to take insufficient account of large social externalities from their activities, including their failure.

The risks of high-powered incentives make it all the more important that boards of directors engage meaningfully with oversight. Indeed, the Board's compliance mandate grew partially in response to address the heightened compliance risks from the managerial incentives model. Yet unlike managers, directors traditionally received only fixed compensation, giving them only 'low-powered' incentives to engage. Many consequently worried that boards were too passive. Thus over the past decade, there has been a sea-change in directors' compensation practices. Directors of US public companies now receive the majority of their compensation in the form of stock. Stock-based director rewards generate more high-powered incentives to monitor managers with shareholder interests foremost in mind. Directors now have greater incentives to engage.

The question is whether the engagement that is encouraged by stock-based director rewards is of the right type. Ideally, a board should have incentives to engage vigorously across all dimensions of its oversight role, including not only the selection of strategy but also the controls seeking to channel managerial efforts towards long-term value and deliver corporate compliance. However, high-powered incentives for directors may serve to skew their attention toward matters likely to deliver short-term share price gains. Rather than serving to rein in managers' excesses, boards may risk becoming their cheerleaders.

Compliance failures commonly produce externalities. The costs can be vast. Enron's failure damaged confidence in equity valuations throughout stock markets. Environmental harms from BP's oil spills; social and political integrity costs associated with money laundering; health effects from wrongly marketed prescription drugs; the lingering economic and social fallout from fraudulent mortgage underwriting in the run-up to the financial crisis: these are just examples of externalities associated with compliance failures. It is difficult to set penalties that will cause firms to internalize appropriately the costs of law violation. Large monetary fines damage the interests of shareholders (and potentially creditors) who are poorly situated to monitor. Moreover, such penalties may disrupt or even bring to an end the economic function of the firm, producing further externalities. A classic response to the "judgment proof" law violator is to target the firm's agents under the criminal law, but it is hard to reach senior managers, because of the way that responsibility and "scienter" is diffused within an organization.

A common modern recourse to these problems is to require the firm to build an internal compliance and monitoring organization, to engage in "self-checking" that would reduce the likelihood of law violation and increase the probability of detection. A board's failure to engage sufficiently with compliance oversight devalues the status of compliance within the organization. Consequently, the board has increasingly been tasked with compliance oversight, both through generalized requirements as to committee structures (independent audit committees for all public firms and, for financial firms, risk management committees), and through judicial recognition that directors' fiduciary duties imply a good faith obligation to ensure the existence of corporate compliance and reporting mechanisms.

When characterizing directors' duties with respect to compliance, a tension exists in the delineation of what is and is not a 'business decision'. It is clear, on the one hand, that boards who consciously sanction a strategy that violates the law cannot claim this was a 'business decision', even if—owing to limited enforcement—such a strategy is value-maximizing for shareholders in expectation. The board has an absolute duty, the courts exhort, to ensure the corporation complies with the law.

At the same time, the amount a corporation chooses to spend on ensuring compliance seems very much to be a 'business decision'. In the absence of knowledge of violations of law or 'red flags', directors' obligations under the so-called '*Caremark* formula' simply require them to ensure the firm has in place *some sort* of compliance system. This is essentially a binary screening of directors' effort: either zero effort was applied (duty breached) or nonzero effort was applied (duty met). Courts consciously insulate the level of investment in compliance from judicial review.

This paper considers the relationship between these changes in directorial compensation and directors' liability for compliance oversight. We make two claims. First, as a positive matter, the shift to stock-based pay has the propensity to undermine directors' engagement with compliance oversight where this conflicts with shareholder value. We describe two distinct ways in which this occurs, through short-termism in stock-based compensation generally and upside bias in option-based compensation more specifically.

Second, in the light of the changes in compensation practice, we argue it is appropriate to rethink the scope of judicial scrutiny of boards' compliance oversight. Although corporations' compliance obligations have grown since 1996, and compensation practices have changed in ways that tend to compromise boards' ability to meet them, the *Caremark* doctrine has remained static. Moreover, the expectation that directors will receive and accumulate company stock provides a discrete target for liability recoveries that does not extend beyond the director's firm-specific wealth and thus ought not substantially to diminish a director's willingness to serve.

To induce effective compliance engagement, we suggest the introduction of greater downside for directors on the revelation of compliance failures. We make two complementary proposals. First, we suggest mechanisms to put at risk wealth accumulated through stock compensation. This could be accomplished variously through a statutory clawback triggered by corporate compliance failures,¹ judicial development of the *Caremark* doctrine, conditions added to deferred prosecution agreements, or best of all, by-law provisions that establish compensation forfeiture regimes for significant compliance monitoring failures.

Second, we consider an agenda for shareholder oversight of director compensation. Recent Delaware caselaw has emphasized the need for shareholder ratification of directors' stock compensation on a detailed basis. Informed institutional investors could help to encourage firms to structure directors' rewards in a more appropriate fashion.

The rest of this paper is structured as follows. Part II describes in the rise in stock-based pay for independent directors, a phenomenon that triggered by a 1995 "Report of the Blue Ribbon Commission on Director Compensation" sponsored by the National Association of Corporate Directors. A follow-on NACD assessment observed that "[w]hereas in 1995 it was common for directors to receive [pension] benefits but no stock, by 1999 the trend was the opposite. By then nearly two-thirds of companies included stock as part of director pay, and under 10% paid [pension] benefits."

Part III describes the problem of "compliance" for the public corporation and how internal compliance structures have arisen to address this problem. An important implication is the importance of the board's role in compliance oversight, first, through supporting the autonomy of the compliance function (and thus its credibility) and second, through signaling to managers and other employees the importance of compliance.

Part IV presents data on the incidence of compliance committees in US public companies. Part V then describes the rise of the *Caremark* doctrine, which articulates an

¹ Existing clawback mechanisms require the disgorgement of executive compensation following accounting restatements. However, not all compliance failures result in accounting restatements.

explicit compliance monitoring oversight role for the board, a helpful if long-overdue innovation, along with a liability safe-harbor for directors. In light of the rise of stock-based pay for directors, the liability safe-harbor is now obsolete: it is both counter-productive and unnecessary. Stock-based compensation may undercut the directors' compliance monitoring incentives in cases where the potential shareholder gains exceed potential liabilities within the directors' settling-up period. Accumulated stock-based compensation also provides a meaningful but limited level of director financial exposure in the event of compliance oversight failures.

Part VI describes alternative avenues to pursue a clawback of directors' stock-based compensation in the event of serious compliance failures. The *Caremark* doctrinal framework could be modified. Shareholders could insist on a clawback mechanism as a condition for the required approval of stock-based compensation plans for directors. Firms could adopt by-law provisions specifying a mechanism for assessing appropriate clawbacks in the event of compliance failures, either through board resolution or a shareholder-initiated bylaw. Firms could agree on a clawback assessment mechanism on an ad hoc basis in settlements to derivative actions. Our preferred alternative is for by-law adoption of a clawback assessment mechanism using alternative dispute resolution strategy.

A particular advantage of this proposal is the added benefit of a public accountability moment for the parties charged with responsibility for overseeing the firm's law compliance. The political economy that sustains economic decision-making by private firms depends, over the long term, on a popular belief that those responsible for controlling corporate misbehavior are personally at risk when compliance fails. The scheme we propose will provide a measure of public "settling up."

II. The Evolution of Directors' Compensation

The board of directors in a modern US public company is usually characterized as performing a 'monitoring' function. The role is to monitor the executives—from recruitment, through the oversight of strategic choices, to the control of conflicts of interest, particularly as regards compensation. Within this model, almost all the members of the board, bar the CEO, are

‘independent’ directors—that is, not tied by any employment relationship to the firm or its management.

The board has not always been conceived in this way. Historically, a board’s role was to provide oversight and input to business decision-making. However, as corporations grew in scale, operational decision-making was increasingly delegated to management. The board was repurposed as a monitoring organ during the 1980s, a conception that came to be reflected in, amongst other things, the ALI's *Principles of Corporate Governance*,² and the ABA’s *Corporate Director’s Guidebook*,³ following the efforts of academics, most notably Melvin Eisenberg.⁴

Traditionally, directors were paid a fixed salary. However, an influential critique in the mid-90s asked how the payment of a fixed retainer for simply showing up to board meetings created incentives for engagement.⁵ The problem was two-fold. Low pay creates little incentive

² ALI, *Principles of Corporate Governance: Analysis and Recommendations*, Vol 1, § 3.02 (1994). Under section 3.02(a): Except as otherwise provided by statute, [t]he board of directors of a publicly held corporation should perform the following functions:

- (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives.
- (2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed.
- (3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions.
- (4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements.
- (5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

³ ABA, *Corporate Director’s Guidebook*, 6th ed (2011), xx.

⁴ See e.g. Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. Corp. L. 997 (1988). See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465, 1518-1520 (2007).

⁵ Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. Rev. 127, 162-64 (1996). Indeed, director compensation was not legally recognized in the United

for effort. But high fixed pay can compromise the independence of directors with respect to executives, given that there are ways in which executives can influence the length of directors' tenure.⁶

Since the mid-90s, however, and partly in response to the critique, directors' compensation has been evolving.⁷ Modern board members of large public companies who have no executive role can expect to receive a total compensation of approximately \$250,000, of which around 60 per cent will take the form of stock-based compensation.⁸ According to a survey of practice in 2016 by FW Cook, a director compensation consultancy, the stock-based component is primarily comprised of restricted stock units (RSU)s,⁹ with a component in some cases of stock options.¹⁰ There is some industry variation, with technology sector firms making slightly higher use of stock-based compensation (70 per cent, on average) and financial services making the least use (47 per cent).¹¹

The shift to stock-based compensation tends to align directors' rewards with the stock price, at least at the point at which they come to sell their stock, which will usually be at the

States until the late 1940s, although informal modes flourished, such as meeting fees, passing of stock tips, and even salaries. *Id.* at 138, 142. As of 1979, the median NYSE firm paid an annual director retainer of less than \$10,000. SEC STAFF REPORT, S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 96TH CONG., SEC STAFF REPORT ON CORPORATE ACCOUNTABILITY (Comm. Print 1980) (surveying 1200 major firms drawn from NYSE, Amex, Nasdaq, and OTC/regional exchanges in 1978-79), at 605 tbl.9.

⁶ [Expand]

⁷ See Eliezer M. Fich & Anil Shivdasani, *The Impact of Stock-Option Compensation for Outside Directors on Firm Value*, 78 J. BUS. 2229, 2229 (2005) (noting that the number of Fortune 1000 firms using stock-based remuneration increased from just over 200 in 1992 to almost 500 in 1995).

⁸ FW Cook, 2016 Director Compensation Report, 5-6 (2016).

⁹ [Explanation of RSUs.]

¹⁰ Cook, above n 8, 6. Options are very much a minority pursuit, accounting for only 3 per cent of mean director compensation at large public companies: *id.*

¹¹ *Id.* The use of options also varies across industries, from 8 per cent of total director compensation in the technology sector to only one per cent in the financial sector: *id.*

end of their tenure plus a dignified waiting period.¹² Of course, direct changes in the value of equity compensation is only one channel through which directors' wealth is affected by changes in their firm's stock price. In a seminal study tracking the fortunes of Fortune 500 directors elected in 1994-96 over a 5-year period, David Yermack considered the combined effect of incentives from compensation received, changes in equity ownership, changes in disclosed conflicts of interest, board seats obtained and departed from, in relation to changes in the stock price of their firms. He calculates that directors' personal wealth was increased (reduced) by 11 cents for every \$1,000 increase (decrease) in the market value of their firms.¹³

This is far lower than the intensity of incentives achieved for CEOs.¹⁴ While some have dismissed the idea that directors' stock compensation creates economically meaningful incentives,¹⁵ Yermack points out that, although smaller than for executives, directors' stock-based compensation incentives are 'nontrivial'. In his sample, a one standard-deviation change in a firm's stock market performance results in a change in a director's expected wealth by about \$285,000.¹⁶ The intensity of these incentives seem likely to have increased in interim, as the aggregate amount of director rewards has continued to grow.¹⁷

Independent directors who sit on specific committees are often—but by no means universally—offered some sort of uplift to compensate them for the extra work involved. The traditional practice was to provide 'meeting fees'—paid on a per-meeting basis, but this is being eclipsed, for firms that offer committee-specific uplifts, by a general retainer associated with

¹² 'About a year' is the apparent norm.

¹³ David Yermack, *Remuneration, Retention and Reputation Incentives for Outside Directors*, 59 J. Fin. 2281 (2004).

¹⁴ For example, Fahlenbrach and Stulz (2012) document that CEOs of crisis banks earned \$24 for every \$1,000 increase in firm valuation.

¹⁵ Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* 34 (2004).

¹⁶ Yermack, *above* n 13, 2282.

¹⁷ Yermack's study period coincided with an extraordinary surge in the value of public company stocks at the end of the twentieth century, during which the ratio of executive compensation to firm value fell to an all-time low.

committee membership. As of 2016, 41 per cent of large cap companies offered a retainer for audit committee membership, and a further 21 per cent offered meeting fees, with 38 per cent having no uplift.¹⁸ However, the absolute sums involved in these uplifts are modest. Independent directors sitting on the audit committees of large cap firms that pay retainers for committee membership receive a median uplift of \$10,000. This rises to \$25,000, or approximately one tenth of their ‘base’ director compensation, for chairing the audit committee.¹⁹

III. Corporate Compliance

We now consider an additional role for boards which has gradually emerged in recent years, particularly since the financial crisis. This is as the overseers of firms’ efforts in compliance.²⁰ Understanding this phenomenon requires some background on what is meant by “compliance”, and the sources of expectations regarding firms’ engagement.

Corporate compliance is best understood as a set of institutions established by firms to secure compliance by actors within the firm with norms of good conduct imposed on the firm.²¹ Such norms of good conduct are imposed on the firm through regulatory obligations, for which firms face vicarious liability—often of a criminal variety—for violations by a firm’s employees. The rationale for such vicarious liability is to create incentives for firms to exert effort to monitor and deter misconduct by their employees. This can usefully be unpacked into a series of steps.

¹⁸ FW Cook, *supra* note 8, 13.

¹⁹ *Id.*, 13-14.

²⁰ See e.g., Sean J. Griffith, Corporate Governance in an Era of Compliance, 57 Wm & Mary L Rev 2075 (2015). Compliance concerns have been a significant driver of board transformation since the 1970s. The so-called “questionable payments” scandal in the 1970s generated a push for an audit committee staffed by independent directors, see Gordon, *supra* note 4, 1490-1493, 1516-1520. The adoption of the Sarbanes-Oxley Act after the Enron/ WorldCom accounting and disclosure scandals added to the board’s compliance responsibilities.

²¹ According to the leading casebook, ‘[t]he compliance function is a form of internalized norm enforcement within organizations’. Geoffrey P. Miller, *The Law of Governance, Risk Management, and Compliance*, 137 (2014).

Regulatory obligations are commonly imposed on firms to ensure that they ‘pay their way’ in terms of the social costs of their activities. For example, environmental obligations seek to ensure that the costs of industrial pollution are internalized by polluters and not shed onto society at large. Workplace and product safety regulations set minimum standards for firms with respect to harms to which their work environment or products may expose workers or consumers. Antitrust laws seek to restrict firms’ pursuit of anticompetitive practices, which harm consumers. Laws prohibiting bribery and corruption, such as the Foreign Corrupt Practices Act of 1977,²² seek to prevent firms undermining the functioning of public institutions.²³ Effective enforcement of such regulatory obligations is a key presumption on which the general case for focusing on shareholder interests in corporate governance rests. In the absence of mechanisms that cause firms to internalize social costs, a focus simply on shareholder wealth maximization will create incentives for firms to shift costs onto non-shareholder members of society.²⁴

A challenge with enforcement, especially in complex business activities, is that there is typically an asymmetry of information regarding the character of conduct between those acting on behalf of firms and those firms’ regulators and prosecuting authorities. This weakens enforcement efforts. Where the probability of enforcement is low, very high penalties may be required in order to generate *ex ante* deterrence. But actually imposing such penalties has huge *ex post* costs: jobs may be lost and firms forced into bankruptcy.²⁵

The idea behind corporate compliance programs is that firms are able to monitor misbehavior amongst their employees far more cheaply than are public authorities. Because the firm has better information about its employees’ behavior than the regulator, this

²² 15 U.S.C. §§ 78dd-1, et seq.

²³ See e.g. Susan Rose-Ackerman, The Law and Economics of Bribery and Extortion, 6 Annu. Rev. Law Soc. Sci. 217 (2010).

²⁴ See Oliver Hart and Luigi Zingales, Companies Should Maximize Shareholder Welfare Not Market Value, 2 J. L. Fin. & Acct. 247 (2017).

²⁵ Steven Shavell, The Optimal Structure of Law Enforcement, 36 J. L. & Econ. 255, 279-280 (1993).

delegation is efficient.²⁶ “Compliance” is the name given to institutions established internally by firms in order to carry out such delegated enforcement. Such institutions can reduce the incidence of misconduct and the need for socially wasteful corporate penalties.

But here is the rub. Installing a corporate compliance program will often have an ambiguous effect on firm value. This is because, while it will likely lower the *incidence* of misconduct in the firm, it will also likely increase the rate of *detection* of any misconduct that does occur. Consider that if the sanction imposed on the firm for relevant misconduct is P , and the probability of enforcement is α ($0 < \alpha < 1$), then the firm’s expected sanction cost is αP . Installing a compliance program will likely (i) *reduce* α through a lower incidence of misconduct, but also (ii) *increase* α through a higher detection rate for misconduct.²⁷ If the effect on the firm’s expected liabilities is ambiguous, it is hard for managers to justify expenditure on compliance programs.

So: although firms may be capable of monitoring their people more effectively than regulators, the challenge is how to give firms incentives for this to happen. Authorities in the US have responded by offering *discounts* to corporate penalties for firms that have established an effective compliance program.²⁸ These discounts have at least two components. First, under the DOJ Sentencing Guidelines, credit is given for firms that have implemented an effective compliance program.²⁹ Second, the existence and efficacy of a compliance program is an important consideration for whether authorities will be willing to permit a corporation to enter

²⁶ Jennifer Arlen and Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, 72 NYU L Rev 687 (1997).

²⁷ Jennifer Arlen, The Potentially Perverse Effects of Corporate Criminal Liability, 23 J. Leg. Stud. 833 (1994). This is because the firm’s willingness to self-report is necessary to get prosecutorial credit for more effective compliance regime.

²⁸ Jennifer Arlen, The Evolution of Corporate Criminal Liability: Implications for Managers, in Jeffrey Sonnenfeld & Robert Gandossey (eds), Leadership and Governance from the Inside Out (2004). Brandon Garrett, Too Big to Jail: How Prosecutors Compromise with Corporations (2014).

²⁹ US Sentencing Commission, 2016 Guidelines Manual, §8C2.5(f) (discount of up to 60% of fine for corporations having in place effective compliance and ethics program); §8B2.1 (factors for determining whether corporation had “effective compliance and ethics program”).

into a ‘deferred prosecution agreement’ (DPA)—a sort of negotiated settlement of criminal proceedings.³⁰ While a DPA typically involves the payment of a significant penalty, it avoids the consequences of loss of business licenses that would accompany a full-blown prosecution in many cases: this means that establishing a compliance program reduces the firm’s expected penalties through a discount to the P term. Even if the compliance program has an ambiguous effect on α , it will unambiguously reduce P and thereby the firm’s expected sanction cost. It is now in the firm’s interests to invest in running a compliance program.

However, despite much exhortation, especially from professional consultants who offer to assist in designing compliance programs, relatively little is known about the structure and efficacy of corporate compliance. Corporations are not required to disclose any information about compliance programs under relevant accounting rules, and it is rare for them to do so voluntarily.³¹ Moreover, there is considerable debate regarding how the efficacy of compliance programs should be assessed, giving the obvious difficulties in determining the underlying rate of criminal misconduct. These uncertainties lead some to be skeptical of the utility of the entire endeavor of corporate criminal liability, implying that offering penalty discounts for ‘effective compliance programs’ is likely to stimulate only a waste of resources.³² Others, conversely, point to the incomplete coverage of externalities through ex ante regulation, whether due to considerations of political economy or emergent risks.³³ On this view, liability regimes in place at any given point likely *under-deter* misconduct. Our goal in this paper is not to resolve this difficult question, but the simply to explore how compensating directors in stock affects their incentives with respect to compliance. Consequently, for the purposes of our analytic discussion, we assume that enforcement agencies are capable of assessing, more or less,

³⁰ [empirical literature on DPAs]

³¹ Initial searches of a sample of SEC filings, in conjunction with conversations with a number of professionals working in the field of compliance, corroborate the suggestion that firms seek to minimize disclosure of their compliance activities.

³² See e.g., Daniel R. Fischel and Alan O. Sykes, Corporate Crime, 25 J. Leg. Stud. 319 (1996).

³³ See e.g. Charles Sabel, Gary Herrigel and Peer Hull Kristensen, Regulation under Uncertainty: The Coevolution of Industry and Regulation, Reg. & Gov. (2017).

whether compliance is effective. We consider the consequences of relaxing this assumption in Part [].

A simple model of compliance oversight

Boards are increasingly tasked with *oversight* of corporate compliance activity. Just what this means is contestable. It is clear that boards are not expected to engage in hands-on execution of compliance. But it is also clear that boards are not permitted to completely forego any consideration of whether their firm should be engaging in compliance. Between these two extremes lies considerable variation in possible intensity of oversight.

Our present focus, however, is on how (increasing) use of stock-based compensation may affect board members' incentives in performing their role. These incentives come to bear on decisions the board must make. While the board is not responsible for initiating decisions about the compliance budget, it likely has the ability to veto increased expenditures. Moreover, the board exercises discretion over the pursuit of potential warning signs that the existing compliance program may surface. We now present a simple model that we use to characterize how stock-based pay may undermine directors' incentives with respect to compliance oversight. The intuition is that directors who are paid in stock will tend to view compliance activity as a "cost" with no countervailing benefit in the short run.

Assumptions. We make the following assumptions. Firms vary according to their likelihood of attracting the attention of public enforcers. Absent a compliance program, 'high-risk' firms face an expected enforcement penalty \bar{p}_h , whereas 'low-risk' firms face an expected enforcement penalty \bar{p}_l , where $\bar{p}_h > \bar{p}_l > 0$. For simplicity, all parties are assumed to be risk neutral, and the time value of money is nil.

The proportion of the population of firms that is high-risk is φ ($0 < \varphi < 1$), and the proportion that is low-risk is $(1 - \varphi)$. The value of φ is common knowledge for both directors and investors. Sources of variance in risk of enforcement are grounded in aspects of firms' business practices that are observable to directors but not to investors. These include matters such as the pre-hiring checks on the integrity of employees, how employee compensation practices operate and so forth.

An effective compliance program costs high-risk firms c_h and low-risk firms c_l to implement, where $c_h > c_l > 0$. Compliance activity has no *net* effect on expected probability of enforcement (it reduces expected incidence, but increases expected detection rate, of misconduct).³⁴ However, having an effective compliance program in place leads prosecuting authorities to discount the penalty if enforcement occurs. This discount is never complete, so we denote it as σ ($0 < \sigma < 0.5$). A firm of type i , ($i \in \{h, l\}$) with an effective compliance program in place consequently lowers its expected enforcement penalty to $(1 - \sigma)\bar{p}_i$. A firm that has a compliance program which is *ineffective*, however, receives no discount. To focus the remainder of the discussion on economically interesting cases, we restrict the analysis to cases where it is value-maximizing for firms to implement a compliance program, i.e. for firm i , $\sigma\bar{p}_i > c_i$.

Timeline. There are two periods. At the beginning of the first period ($t = 0$), the firm's market capitalization is v . A director of a firm of type i is tasked with reviewing whether or not the firm should implement a compliance program costing c_i . Any approved expenditure is spent by the firm during the first period.

At the end of the first period ($t = 1$), the firm's financial statements are published. Accounting rules do not require disclosure of compliance expenditure as a separate category, but firms may choose to disclose such information voluntarily.

At the end of the second period ($t = 2$), the firm is potentially the subject of a criminal investigation. Firms that have not invested in compliance programs incur a penalty with expected cost \bar{p}_i , whereas firms that have invested in a compliance program incur only $(1 - \sigma)\bar{p}_i$.

Long-term value maximization. Consider first the benchmark case where directors are motivated to maximize the firm's expected value at the end of the second period ($t = 2$). The decision whether to establish a compliance program can be treated similarly to any other capital budgeting decision for the firm. Under our assumptions it is value-maximizing for firm i

³⁴ See *supra*, text to notes 27-30.

to implement a compliance program because $\sigma \bar{p}_i > c_i$. Investment in compliance yields the firm an expected 'return' at period 2 equal to $\sigma \bar{p}_i - c_i$.

Directors paid in stock vesting at $t = 1$. We now consider how the analysis changes if the directors are paid in stock, which vests in period 1. The directors now have incentives to focus not on the firm's value in period 2, but on its market capitalization in period 1.

Disclosure and revelation. At $t = 0$, investors do not know firm i 's type. However, if the firm discloses its level of compliance expenditure at $t = 1$, this will reveal its type at that point. Because high-risk firms face a greater residual expected enforcement penalty than do low-risk firms, this revelation will cause the market capitalization of low(high)-risk firms to increase (decrease). This revelation effect will be salient for directors who are concerned with maximizing the market capitalization at $t = 1$.

Disclosure decision. Might directors of a high-risk firm choose simply to disclose lower compliance costs than their firm actually incurred? If a high-risk firm invests in a compliance program costing c_h but only discloses c_l of compliance costs, would this permit high-risk firms to continue to pool their market valuation with low-risk firms at $t = 1$? It seems unlikely that directors would procure their firm to misstate its overall expenditure, as this would subject them to personal civil and criminal liability for securities fraud. More plausibly, they might take advantage of the fact that firms are not required to disclose compliance expenditure as such to simply allocate the costs to other categories—for example, general employment costs. However, this will also be unfruitful, because investors will treat the additional expenditures simply as reducing earnings going forwards, which will also lower the firm's valuation.³⁵ Consequently, directors may be expected to support truthful disclosures in period 1. This then calls into question the impact of compensation incentives on the decision regarding investment in compliance.

³⁵ Indeed, investors may be able to infer the firm's type from the presence of an unexplained earnings shock in period 1.

Compliance decision. In light of the analysis of the disclosure decision, consider now how the directors' concerns about revelation at $t = 1$ may affect their incentives regarding the compliance investment decision at $t = 0$. Directors of high-risk firms may be tempted to implement only a compliance program of the sort that would be adequate for a low-risk firm, but not a high-risk firm. Such firms would then (truthfully) disclose compliance expenditures of c_l . Investors would not now be able to distinguish between high and low-risk firms at $t = 1$.

However, this results in high-risk firms not expending enough resources on compliance to deliver an effective compliance program. Note that for a high-risk firm to spend only c_l does not maximize the firm's expected value at $t = 2$. This provides only an ineffective compliance program, which does not generate any reduction in penalties from the authorities should enforcement occur at $t = 2$. A high-risk firm that spends only c_l on compliance consequently reduces its expected value at $t = 2$, relative to a high-risk firm that spends c_h , by $\sigma\bar{p}_h - c_h - c_l$. That is, the firm foregoes the opportunity to receive a discount on expected enforcement costs through having had an effective compliance program, and wastes resources on an ineffective compliance program.

Rational investors will infer that if all firms disclose c_l , then with probability φ , a firm making low compliance expenditure is in fact high-risk. Investors will expect firms' average expected compliance and enforcement costs under these circumstances to be as follows: $(1 - \varphi)\sigma\bar{p}_l - c_l + \varphi(\bar{p}_h - c_l)$. This is the weighted mean of low-risk firms which implement effective compliance programs, and high-risk firms which do not (and so receive no discount to their expected enforcement penalties) and which incur wasteful expenditure on ineffective compliance in order to mimic low-risk firms.

If directors of a high-risk firm choose to invest c_h , they will reveal the firm's type at $t = 1$. Investors will assess the firm's expected compliance and enforcement costs as $\sigma\bar{p}_h - c_h$. Directors focused on maximizing the firm's market capitalization at $t = 1$ will consequently choose only to invest c_l where the following condition holds:

$$\sigma\bar{p}_h - c_h > (1 - \varphi)(\sigma\bar{p}_l - c_l) + \varphi(\bar{p}_h - c_l)$$

$$\Rightarrow \bar{p}_h(\sigma - \varphi) - (c_h - c_l) - (1 - \sigma)\varphi\bar{p}_l > 0 \quad (1)$$

As $c_h > c_l$ and $\sigma < 0.5$, inequality (1) will only be satisfied where φ is small relative to the population at large and \bar{p}_h is large relative to \bar{p}_l . This implies that underinvestment in compliance at high-risk firms will be most likely when: (i) there is dispersion in firms' risk of prosecution relative to peers; and (ii) only a modest fraction of firms faces high risk of prosecution.

IV. Establishment of Compliance Committees

In order to enhance our understanding of directors' role in compliance regimes, we investigate the extent to which public companies inaugurate committees of independent directors specifically tasked with overseeing compliance. Such committees are distinct from, but have supervisory responsibility for, the firm's compliance executives. As we have explained, firms typically do not disclose information regarding the extent and costs of their internal compliance programs. However, if a company establishes a board committee that specifically focuses on compliance, the committee's charter is generally disclosed on the company's website and sometimes also in its proxy material.³⁶ The committee charter typically describes in general terms the compliance program of the company and determines the role of the director as a compliance committee member. Such disclosure can allow investors to assess more accurately the extent to which the company is supporting its compliance program. In that sense, the

³⁶ New York Stock Exchange listing manual only requires the disclosure of three committee charters (audit, compensation, and nomination/governance committees) on a company's website and silent about additional board committee charters. In practice, however, companies disclose a committee charter of every committee in addition to the three required ones, presumably in order to avoid any potentially misleading omissions regarding the interpretation of the charters of the committees for which disclosure is mandated. See Website Posting Requirement and Disclosure Requirements of NYSE Listed Company Manual Section 303A.07(b). See also SEC Regulation S-K Item 407(d)(1) (SEC Regulation S-K requires proxy statement disclosure of whether current audit committee charter is available on company's website and, if so, website address. If not so available, company should include charter as proxy statement appendix at least once every three years or in any year in which charter was materially amended. If charter is not on company's website and not in proxy statement for that fiscal year, disclose year charter was most recently included in proxy statement).

implementation of a compliance board committee is not merely cosmetic, also reveals information about the firm's chosen compliance system.

Table 1. Incidence of Compliance-Oriented Board Committees by Industry Sector

Industry Sector	Compliance Board Committee	
	Frequency	%
Aerospace & Defense	5	1.1%
Automobiles & Parts	3	0.7%
Banks	94	22.8%
Business Services	6	1.5%
Construction & Building Materials	3	0.7%
Education	2	0.5%
Electricity	5	1.2%
Electronic & Electrical Equipment	7	1.7%
Engineering & Machinery	6	1.5%
Food Producers & Processors	4	1.0%
Forestry & Paper	2	0.5%
General Retailers	2	0.5%
Health	64	15.5%
Insurance	7	1.7%
Investment Companies	82	19.9%
Leisure & Hotels	16	3.9%
Media & Entertainment	2	0.5%
Mining	2	0.5%
Oil & Gas	10	2.4%
Pharmaceuticals and Biotech	45	10.9%
Software & Computer Services	11	2.7%
Specialty & Other Finance	25	6.1%
Steel & Other Metals	2	0.5%
Telecommunication Services	3	0.7%
Transportation	5	1.2%
Total	413	100.0%

Note: data are from BoardEx over the period 1999-2017. 'Compliance board committee' indicates that a firm established a committee explicitly referencing 'compliance' in its title.

We investigate the incidence of compliance committees amongst US public companies using data from BoardEx. Among the universe of [7,534] U.S. companies featured in BoardEx³⁷ database from 1999-2017, only [415, six per cent] have established a board committee having the term “compliance” explicitly in its title. Table 1 shows the industry distribution of firms that have established of such committees. Of those firms that have established a committee explicitly referencing ‘compliance’ in its title, the most common approach (in 62 per cent of cases) is to set up separate ‘Compliance’ and ‘Risk’ committees, staffed by independent directors and distinct from the audit committee. However, substantial minorities of firms have set up a ‘Compliance and Risk’ committee (17 per cent of cases) or simply modified the title of their Audit Committee to ‘Audit and Compliance’ (21 per cent). As can be seen, compliance board committees are most common in the financial sector: if we combine Banks (94), Insurance (7), Investment Companies (82), and Specialty/Other Finance (25), financial institutions make up almost 50% of the companies that have compliance board committees. Moreover, Health (64) and Pharmaceutical (45) industry together comprise another 26% of the companies that have invested in implementing compliance board committees.

It is notable that financial services and healthcare are two of the most heavily regulated industrial sectors. This may be expected to increase the expected costs of enforcement of misconduct, thereby justifying expenditure on a compliance program. However, it also results in a higher enforcement rate for these industries. This has two consequences for the framing of our model. First, for firms on the receiving end of enforcement, their status as high-risk has been revealed through the enforcement action, and they are now at pains to reduce this perception going forwards. Investing in a compliance program *after* enforcement is rational on this view. We obtain data on the prosecution of public firms from the Corporate Prosecution Registry established at the University of Virginia Law School.³⁸ In the limited number of cases

³⁷ BoardEx contains information about in-depth profiles of over 500,000 of the board members and executives of public companies and private entities. The data are updated on a daily basis.

³⁸ <http://library.law.virginia.edu/corporate-prosecutions/>. See also Brandon Garrett, Nan Li and Shivaram Rajgopal, Do Heads Roll? An Empirical Analysis of CEO Turnover and Pay When the Corporation is Federally Prosecuted, UVA Law School Law & Economics Research Paper 2017-11 (2017).

[16] for which we have data regarding both prosecution and establishment of a board compliance committee, [12] or [75%] inaugurated the compliance committee only *after* prosecution had occurred.

Second, for firms in highly-regulated sectors for which the enforcement rate is high but that have not yet been recipients of enforcement, investors are likely to begin to factor in expectations about potential enforcement into their valuations. For such firms it may increase value, even in the short run, to disclose to investors the implementation of a compliance program.

[We consequently view these descriptive results as consistent with the predictions of our analysis. Ongoing empirical research is investigating links between compensation and compliance].

V. Directors' liability for compliance failures

If a company faced a criminal prosecution or serious civil enforcement action and pays a penalty (either following conviction, final judgment or a settlement) directors may face potential liability to their company. The most egregious case would be if directors had actually approved a course of corporate conduct that to their knowledge or by necessary inference would involve violations of law. Where a conscious decision is taken to violate the law, the board cannot avail itself of the protection of the business judgment rule. Such cases, although not unheard-of, are rare.³⁹

More common are allegations that directors failed to act in response to concerns about potential criminal misconduct within their firm. Such failure to act can be divided into 'acute' and 'chronic' versions. In the acute version, directors are presented with a so-called 'red flag'—

³⁹ See e.g., *Louisiana Municipal Police Employees' Retirement System v. Pyott* 46 A.3d 313 (Del. Ch., 2012) (Allergan board approved of Botox marketing beyond FDA permitted uses. It is unclear to what extent this reflects a low incidence of such decisions as opposed to high circumspection on the part of those making them.

Information suggesting that the risk that misconduct may be occurring within the firm is much higher than had previously been believed.⁴⁰

Liability for chronic failure to act is commonly referred to as ‘*Caremark*’ liability, reflecting its first postulation by Chancellor Allen in *In re Caremark International Inc., Derivative Litigation*.⁴¹ As Allen put it:⁴²

[I]t would, in my opinion, be a mistake to conclude that ... corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

However, he went on to characterize the *extent* to which the board requires the company to implement compliance systems as a question of business judgment:⁴³

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law.

Directors therefore face liability for chronic failure to engage in oversight only if such lack of engagement amounts to a failure to make “a good faith judgment that the corporation's

⁴⁰ *Graham v Allis-Chalmers; In re Massey Energy Company Derivative and Class Action Litigation*, 2011 WL 2176479 (Del. Ch., 2011); *Melbourne Municipal Firefighters’ Pension Trust Fund v. Jacobs*, 2016 WL 4076369 (Del. Ch., 2016).

⁴¹ Del. Ch. 1996.

⁴² *Caremark* at 970.

⁴³ *Id.*

information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations.” This continuing monitoring obligation, which has subsequently been expressly characterized as part of a directors’ overarching duty of loyalty,⁴⁴ would, in Chancellor Allen’s view, only be violated by “a sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure a reasonable information and reporting system exists,”⁴⁵ or as it was put by the Delaware Supreme Court in *Stone v. Ritter*:⁴⁶

(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

It does not appear excessively reductionist to characterize this continuing monitoring obligation as binary: either there is zero effort, or there is nonzero effort. Any level of positive effort will suffice for directors to meet their fiduciary obligations in this context. This is reflected in statements regarding the sorts of board-level failures that might ground a claim for liability:⁴⁷

contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.

The recent case of *Horman v. Abbey*,⁴⁸ concerning allegations of *Caremark* violations by the board of UPS in relation to the transportation of illegal tobacco products, provides an

⁴⁴ *Stone v. Ritter*.

⁴⁵ *Caremark* at 971.

⁴⁶ *Stone v. Ritter* at 370.

⁴⁷ *Guttman v Huang* 823 A.2d 492, 507 (Del. Ch., 2003). See also *David B. Shaev Profit Sharing Account v Citigroup, Inc.* 2006 WL 391931 at 5 (Del. Ch., 2006).

⁴⁸ 2017 WL 242571 (Del. Ch., 2017).

illustrative example. The fact that the plaintiffs conceded that the board had established an Audit Committee whose responsibilities included “oversight of ‘the Company’s compliance with legal and regulatory requirements. ...’” and that the board was “provided updates about legal compliance through reports from the UPS Legal Department” was fatal to their claim that the board had failed to implement any reporting or compliance systems.⁴⁹ By simply establishing these structures, the board had done enough to meet their *Caremark* obligation.

The problem with this binary approach, in light of the analysis in the previous section, is that it gives directors no incentive from the standpoint of their fiduciary duties to push for more than minimal compliance, or to attempt to scrutinize the efficacy, as opposed to the existence, of their firm’s compliance program.

VI. Reconsidering *Caremark*? Avenues for Change

The *Caremark* framework is ripe for reconsideration, though a revision of the judicial doctrine is not the only avenue for change. *Caremark* was decided in the midst of shift in the composition of the board, directors’ compensation, and directors’ duties but before public realization of the implication of these changes. The Delaware takeover jurisprudence of the late 1980s and early 1990s looked to the independence of directors as a critical factor in deference to target board adoption of defensive measures in response to a hostile bid. Over the 1985-1995 period, the fraction of independent directors for dramatically increased, from under 40% to over 60% on average.⁵⁰ Institutional investors focused on stock-based compensation as a substitute for the incentive alignment pressures of a hostile bid. Executive compensation came to include an increasingly large fraction of stock options and other stock-based elements, borrowing for large public companies a compensation strategy that had previously been used mostly by cash-starved tech firms. To heighten the incentives for performance-monitoring by the newly-arriving independent directors, director compensation moved to options and other forms of stock-based pay. The focus on performance, accounted for increasingly in stock-based terms,

⁴⁹ *Id.*, at 8.

⁵⁰ Gordon, at 1474-75, figs. 1 and 2.

gives management teams increased reason to press, if not ignore, the legal limits. Performance fictionalization, evidenced most vividly by the Enron episode, was one manifestation, but the raft of civil and enforcement actions across a wide range of industries suggests a more general compliance problem.

In holding that a board had a duty to assure an adequate “information and reporting system.” *Caremark* was responsive to the emergent concerns about corporate law compliance. In its high standard for director liability for deficient compliance oversight – requiring a “sustained or systematic failure of the board to exercise oversight” – the *Caremark* court was operating in the post-*Smith v. Van Gorkam* framework, in which the threat of director liability was seen as a serious impediment to recruiting capable outside directors. Monetary liability was a Pandora’s box in this regard, since there is no obvious limit to exposure and D&O liability policies may include carve-outs for corporate wrong-doing that would make coverage litigable. Moreover, in light of the exculpatory elements of sec. 102(b)(7), director liability could arise only for breach of the duty of loyalty and, because of the absence of a direct conflict, would require abject dereliction of duty as to be “disloyal.”⁵¹

The rise of stock-based pay for directors changes things. As the model shows, it gives the directors self-interested reasons for tolerating a sub-optimal compliance regime, both ex ante in the design of the regime and ex post, in the assuring adequate follow-up of warning signs. Directors have a conflict of interest both from a shareholder point of view, if they can exit before realization of the law violation, and from a social point of view, if their incentives are dulled in monitoring the company’s law compliance. Moreover, the stock-based pay provides a way to establish and cabin the directors’ potential monetary liability. Firms often require directors to retain stock that they receive in the course of their service as directors and could strengthen this accumulation practice. “Pari passu” liability is not sufficient exposure for a director/shareholder who accedes to a suboptimal compliance regime. The directors are

⁵¹ Stone v. Ritter; Lyondell Chemical v. Ryan, 2009.

responsible for overseeing the design and workings of the regime. A forfeiture, a clawback of accumulated stock tailored to the extent of the oversight failure, is the proportionate measure.

This is a normative argument, based on an evolving sense of the duties of public company directors, the increasing importance of stock-based compensation, and the sense that appropriate accountability for individuals who have compliance oversight responsibility helps sustain the public acceptance of the private-seeking public company even when law violations become manifest. We see two related problems: First, how will “responsibility” and “accountability” be metered in the circumstances of an actual case. Second, what would be the route by which heightened compliance oversight responsibility/liability exposure was imposed on directors.

The problem of liability assessment is not easy. If a firm pays a \$1 billion fine for illegal off-label drug marketing and the directors were found meaningfully at fault in overseeing the establishment and operation of a compliance regime, should that wipe out all accumulated stock of all the directors? That predictably could undercut incentives for on-going vigorous performance monitoring. The uncertainty about the design of “optimal” compliance regimes adds another difficult element. Ironically figuring out “what the directors knew and when did they know it” is probably easier. Our preference is for an alternative dispute resolution procedure that would over time generate learning about compliance regimes that might usefully inform practice as well as instill accountability. For example: if the firm resolves a compliance enforcement action, criminal or civil, through payment of a fine or accepting some other sanction, an appropriate board committee, perhaps the governance committee, should trigger an “accountability proceeding.” This proceeding should be presided over by a panel of compliance and industry experts, perhaps three, who will conduct an internal investigation that would evaluate the compliance system within the firm as well as the particulars of the compliance failure, and determine the extent of director responsibility and the level of clawback of accumulated stock. The panel’s findings and determinations should be made public.

This proceeding will have three advantages: First, it weighs and assesses responsibility in an expert way. Second, it will help generate case studies that will help all parties understand what makes for an effective compliance regime. Third, it will add to deterrence by providing information to the market in director services. As we have noted previously, there seems little reputational loss for a director of a company that is subject to an enforcement action, with the exception of accounting fraud for audit committee members. This is probably because derivative actions asserting compliance failure may not survive a motion to dismiss on demand futility grounds, because of difficulty in pleading that directors' failures reached the *Caremark* level. An expert panel determination will provide highly relevant information to shareholders about a director's engagement with compliance issues. Even a small penalty, in dollar terms, could have strong effects on director behavior because of the public consequences.

There are a number of different routes to this outcome, a judicial route and a shareholder route. The judicial route would entail a revisiting of *Caremark* and *Stone v. Ritter* in light of the changes in director compensation that give rise to structural duty of loyalty issues. This would mean fewer demand-futility dismissals and thus more deposition and trial testimony on compliance structures and engagement and an evolution of settlement structures that would include some clawback.

The shareholder route has two different approaches. The stock exchange listing rules require shareholder approval of equity compensation plans.⁵² Under state law (Delaware in particular), shareholder approval of stock-based pay for directors seems a critical element in assuring that a business judgment rule standard rather than an entire fairness standard governs in the event that such grants are subsequently challenged as excessive and resulting from director self-dealing.⁵³ Shareholders, for example, institutional shareholders, who believe that directors' stock-based compensation should be subject to clawback in the event of compliance

⁵² See NYSE Listed Company Manual § 303A.08; Nasdaq Listing Rule 5635(c).

⁵³ The recent important cases are *Seinfeld v. Slager* (Republic Services), 2012 WL 2501105 (Del. Ch. June 29, 2012); *Calma v. Templeton* (Citrix), 114 A.3d 563 (Del. Ch. 2015); *Espinoza v. Zuckerberg* (Facebook), 124 A. 3d 47 (Del. Ch. 2015); and *Investors Bancorp*, C.A. No. 12327-VCS (Del. Ch. Apr. 5, 2017).

failures, could withhold their vote based on appropriate undertakings in the plan documents for a decision procedure like the one described above. Since stock-based compensation raises loyalty concerns, it is appropriate for shareholder to set limits on the terms of such equity grants.

Alternatively, shareholders could add a clawback determination process through an amendment to corporate by-laws using the shareholder initiative power under Delaware corporate law and similar such laws.⁵⁴ This would invite negotiation with the board over a scheme that could workably address the clawback scheme. Such a measure would be shareholder “self-help” that does not require legislative change or even widespread adoption across all firms. An organization like ISS or the Council on Institutional Investors might devise model by-law provisions that would be available for shareholder initiative. ISS might well initiate a consultation among its shareholder constituents to evaluate the demand for such a provision.

[Conclusion]

⁵⁴ See Del. Gen. Corp. L. §109.